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Global Investment Perspectives

Fourth Quarter 2018

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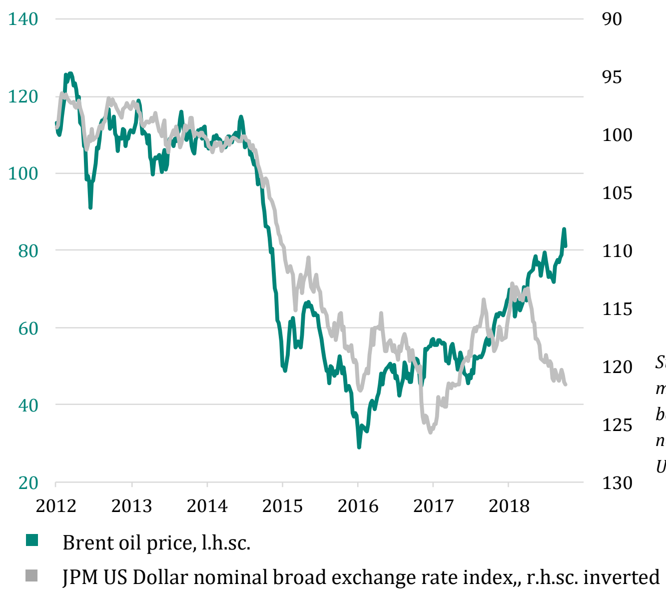
Growth Concerns Weighing on Global Financial Markets

- **The global economy has reached a growth peak by mid-2018. However, there are increasing signs of a notable growth slowdown into 2019. In addition, downside risks have intensified as a result of the looming US-Chinese trade war.**
- **The Federal Reserve has confirmed its medium-term outlook on monetary policy tightening. For December, we expect a next rate hike, followed by further hikes in the course of 2019, which will raise the FED fund rate to around 3.25% by the end of next year.**
- **Growing concerns on the adequate compensation of the expected production outages due to imposed sanctions on Iran are dominating the oil market. These supply-side factors have driven oil prices beyond their longstanding correlation to the US dollar (see figure below).**
- **In contrast to the global slowdown, the Saudi economy is expected to experience a growth acceleration into 2019 which is supported by a higher oil output and an expansionary fiscal policy spurring growth of the Non-oil economy.**
- **Global financial markets have been subject to corrections in October due to rising concerns on the global growth outlook. In our asset allocation, we cut our overweight in US equities as the divergence story versus Emerging Markets is partly priced in at current levels.**
- **The Saudi equity market has corrected from its high levels reached by mid-year. In our view, the fundamental case for TASI is still valid and, hence, offers upside potential for the market in 2019. This is further underpinned by a moderate valuation in absolute and relative terms.**

Oil Price Decoupling from US Dollar Dependency



Supply-side factors on the oil market driving the oil price beyond its longstanding negative relationship to the US dollar.

source: Bloomberg

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Part 1: Global Economy

A Global Outlook with Increased Downside Risks

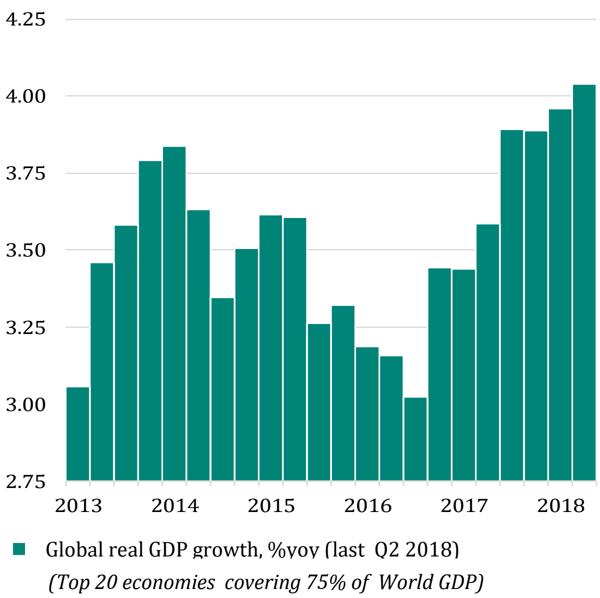
Until mid-2018, global economic growth has continued to accelerate. Based on our proxy indicator for the global economy, which includes the largest 20 economies, covering approximately 75% of global GDP, growth in the second quarter of 2018 was just over 4% year-on-year – a figure last seen 6 years ago (see figure 1).

However, there are increasing signs that this growth momentum should notably decrease in the second half of 2018 and especially in 2019. We have already referred to this point in earlier editions of this report. In particular, the main drivers of the recent global acceleration in growth are showing clear signs of slowdown. This applies to the fading fiscal stimulus of the recent years in the majority of the major economies, the increasingly less accommodative monetary policy of the major central banks, the signs of fatigue on the global financial and real estate markets and, last but not least, the sharp rise in energy costs for the manufacturing industry in the recent past. All these factors indicate that global economic growth should considerably slow down over the next 12-24 months.

This view is also shared by the IMF, which in its fall forecast in October 2018 draws a thoroughly mixed picture of the global economy. For the first time in more than two years, the global growth forecast has been revised downwards (see table 1). The IMF now expects growth of 3.7% for the global economy in 2018 and 2019, after previously forecasting a growth rate of 3.9% for these two years. The correction of the growth forecasts is broad, but mainly affects emerging markets, which were previously considered as growth drivers. For the emerging and developing economies, the IMF expects overall growth of 4.7% in 2018 as well as in 2019. This represents a revision of -0.2% for the current year and not less than -0.4% for next year. This illustrates that the risks of a more pronounced growth slowdown are mainly in emerging markets.

By contrast, growth in the USA is expected to continue to accelerate, at least in the current year, against the backdrop of a pro-cyclical fiscal policy. In the short term, therefore, the divergences in the global economy should continue to expand. For the US, the IMF still expects annual growth of 2.9%. On the other hand, advanced economies excluding the US are expected to weaken on average to about 2.1% (see figure 2). This divergence is also reflected in the different mood of consumers and companies in those countries. While US consumer sentiment is set to reach new highs, consumer sentiment in other industrialized countries is clearly weakening (see figure 3). In the case of Europe, the economic outlook is also burdened by increased political risks. The precise framework of the UK exit from the EU

Figure 1:
Global Growth Peaking by Mid-Year 2018



source: Bloomberg, IMF, RC estimates

Table 1:
Global GDP Growth

	2016	2017	*2018f*	*2019f*
World	**3.2**	**3.7**	***3.7***	***3.7***
Advanced Economies	**1.7**	**2.3**	***2.4***	***2.1***
USA	1.5	2.2	*2.9*	*2.5*
Euro Area	1.8	2.4	*2.0*	*1.9*
Japan	0.9	1.7	*1.1*	*0.9*
United Kingdom	1.9	1.7	*1.4*	*1.5*
Emerging Economies	**4.4**	**4.7**	***4.7***	***4.7***
China	6.7	6.9	*6.6*	*6.2*
India	7.1	6.7	*7.3*	*7.4*
Russia	-0.2	1.5	*1.7*	*1.8*
Brazil	-3.5	1.0	*1.4*	*2.4*
Saudi Arabia	1.7	-0.9	*2.5*	*2.8*

source: IMF, Saudi Arabia: RC estimates remains unclear, while the new government in Italy is planning substantial fiscal expansion in 2019 with a budget deficit clearly exceeding the EU directives which has already caused turbulence on financial markets.

FED Confirms Interest Rate Forecasts

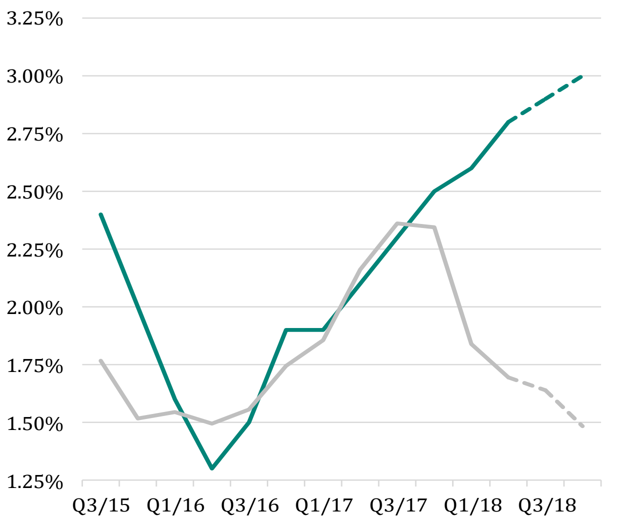
The excellent macro conditions in the US also has an impact on monetary policy. In September, the Federal Reserve raised interest rates for the third time this year. In addition, the FED officials in their quarterly published forecasts assume that a fourth rate hike will take place in December and interest rates will be raised three times next year as well (see figure 5). Hence, the FED confirms its accelerated policy normalization path already projected in its June forecasts. In our view, this is a realistic scenario as inflationary pressures are expected to increase in the course of 2019. Unemployment is at the record low level of 3.7%. So far, this has only to a limited extent led to increased wage pressure (see figure 4). However, it seems rather likely that labor costs will gradually increase next year. Against this background, we forecast US Fed fund rates to be in a range of 3.00% - 3.50% at the end of next year. As highlighted in the last report, this will continue to fuel USD strength, especially against emerging market currencies.

The Looming Trade War – A Risk for Global Growth

The scenario of higher US interest rates, a stronger US dollar, sharply increased energy costs due to rallying oil prices, combined with a general slowdown of global economic growth are rather challenging prospects for many emerging market economies. Added to this is the looming risk of a trade war that could hit some emerging markets particularly hard. Due to their low export ratio relative to GDP the US is much less affected in the case of retaliating measures of countries subject to punitive trade tariffs (see figure 7). The target of US trade policy is specifically China, with which the US has the largest bilateral trade deficit (2017 376bln USD). During the third quarter, the US imposed tariffs on Chinese imports of 250blnUSD. This was subsequently answered by the Chinese government with import tariffs totaling 110bln USD on selected US import products. The US has already threatened to impose trade tariffs on another 260bln USD of imported goods from China, which could eventually be introduced in January 2019. Thus, the entire amount of Chinese imports would be subject to trade tariffs in this case.

As early as the second quarter of this year, global trade has already shown clear signs of slowing growth (see figure 6). Should there be further aggravation of the global trade war, an additional weakening has to be expected. This could also negatively impact the business climate of the global manufacturing industry, which is closely tied to global trade. That in turn could also affect investment spending of this industry. In the event of an outright trade war, which would also include US tariffs on car imports, the IMF expects global growth to be negatively impacted by 0.8% in 2020. The forecasts

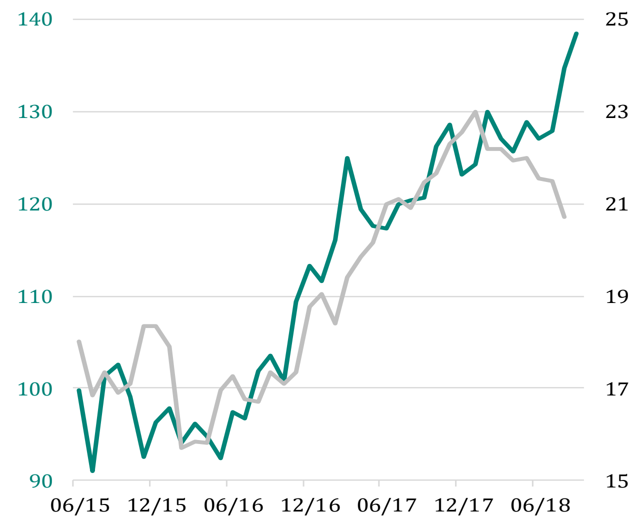
Figure 2:
Growing Divergence US vs. Rest of the World



GDP growth rate USA, quarterly, %yoy
GDP growth rate Advanced economies excl. US, quarterly, %yoy
(Q3,Q4 2018 Bloomberg economists' consensus forecasts)

source: Bloomberg

Figure 3:
Diverging Consumer Confidence



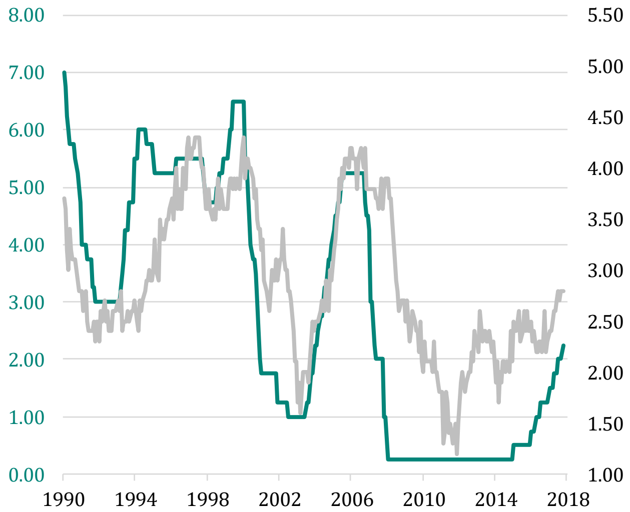
US Consumer Confidence, l.h.sc.
Consumer Confidence average Euro area and Japan, r.h.sc.

source: Bloomberg

for the US and China for 2019 have already been revised downwards due to the existing trade conflict. In the case of the US economy from 2.7% to 2.5% and for China from 6.4% to 6.2%. In a worst case scenario, Chinese growth could even be negatively affected by -1.6% according to the IMF.

However, the risks for emerging economies should not be generalized either. In their majority, emerging economies are in a more robust condition compared to previous crises. In particular, Asian emerging economies, hit particularly hard in the Asian crisis of 1997/98, now exhibit solid current account surpluses and have imposed increased fiscal discipline. Therefore, the risk of indiscriminate contagion across emerging markets and, hence, the outbreak of a crisis of a broader dimension is currently a remote scenario, but from an investor's point of view, some caution is undoubtedly appropriate.

Figure 4:
FED Fund Rates and US Wage Growth

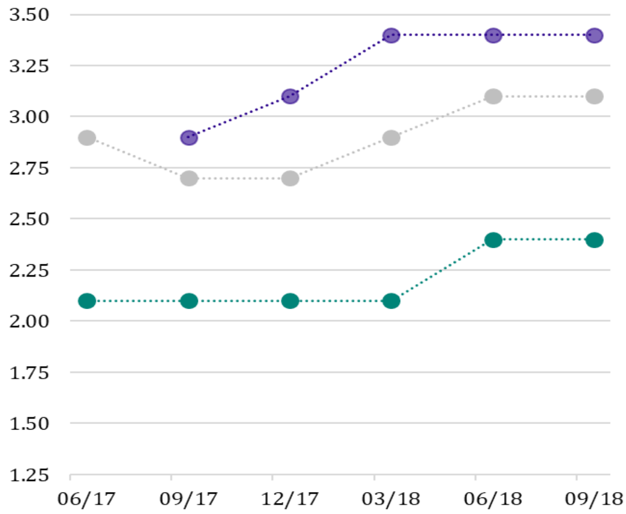


FED Fund rate, l.h.sc.

US wage growth, monthly, %yoy, r.h.sc.

source: : Bloomberg

Figure 5:
Federal Reserve Officials' Interest Rate Forecasts

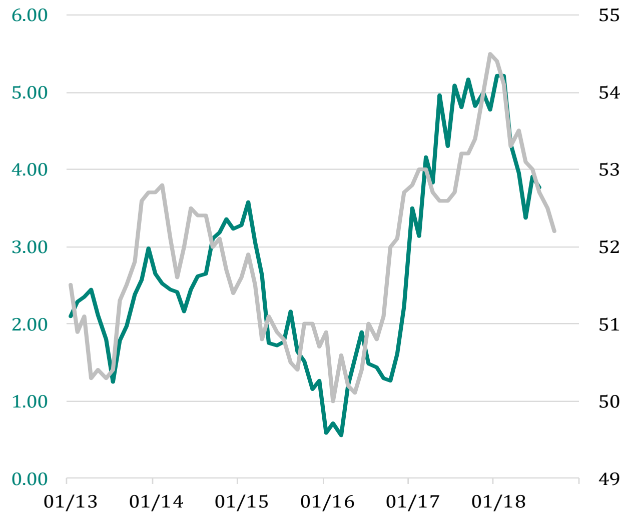


FED officials' median forecast for FED Fund rate at:

Dec 2018 | Dec 2019 | Dec 2020

source: Federal Reserve

Figure 6:
Global Trade and Business Climate Faltering

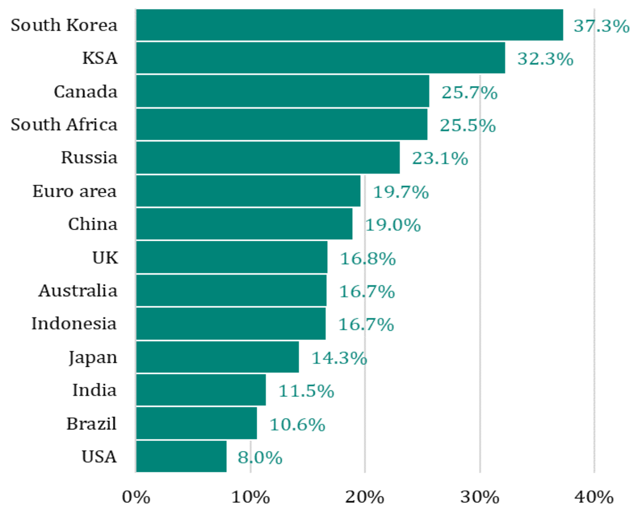


World trade volume, monthly, %yoy, 3MMA, l.h.sc.

PMI Global Manufacturing industry, r.h.sc.

source: Bloomberg, CPB World Trade Monitor

Figure 7:
Importance of Exports for Selected Countries



Merchandise exports as % of GDP (2017)

source: Bloomberg

Part 2: Oil Market

Supply-Side Driven Market

Oil prices continued their rally, since mid of last year to end up above 80USD in the case of Brent by mid-October (see figure 8). Currently, the oil market is primarily driven by supply-side factors. Demand-side factors only play a minor role. This can be seen, for example, in the decoupling of oil prices from the development of the US dollar (see Figure 9). Typically, there is a negative correlation between oil prices and the US currency, as a majority of oil-consuming countries are not tied to the US dollar, and therefore a USD appreciation represents an energy price increase, which has a negative impact on demand. Despite a significant strengthening of the trade-weighted US Dollar index since April of this year, the price of oil has increased significantly over the same period.

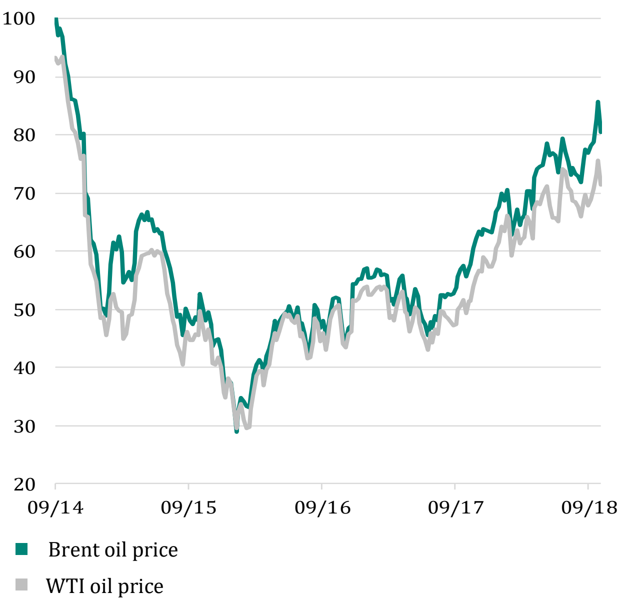
At this juncture, the market is focused on the question of how much oil will be withdrawn from the market by the reintroduction of sanctions against Iran in November 2018 and to what extent this loss can be compensated by other oil producing countries. In fact, oil production in Iran declined by 450k mbd between May and September according to secondary sources (see figure 11). Total crude oil exports declined by almost 800k bd over the same period. So far, this production shortfall has been compensated within OPEC. Estimates based on secondary sources show that OPEC production increased by about 700k bd over the same period (see figure 10). The lion's share of this production increase can be attributed to Saudi Arabia with about 560k bd. However, based on latest estimates Iran could potentially witness an overall output reduction in the order of up to 1.5 mbd due to the US sanctions. This implies that a further production decline of up to 1 mbd has potentially to be expected. The key question will, therefore, be which producers can step in here.

The US Department of Energy (IEA), estimates the spare capacity of OPEC at about 1.5 mbd, according to estimates by Bloomberg it is just over 2 mbd (see figure 12 and 13). Most of this is attributable to Saudi Arabia according to both sources. Assuming that these estimates are realistic, a further production outage in Iran could ultimately be compensated. However, this would reduce the spare capacity of OPEC to a minimum. Further unexpected production losses in other countries would thus directly lead to a shortage on global oil markets, which would boost oil prices accordingly. Based on this scenario and with a view on all related uncertainties, oil prices should remain high at least until the end of the year, while price volatility will stay elevated.

Rebalancing Expected in 2019

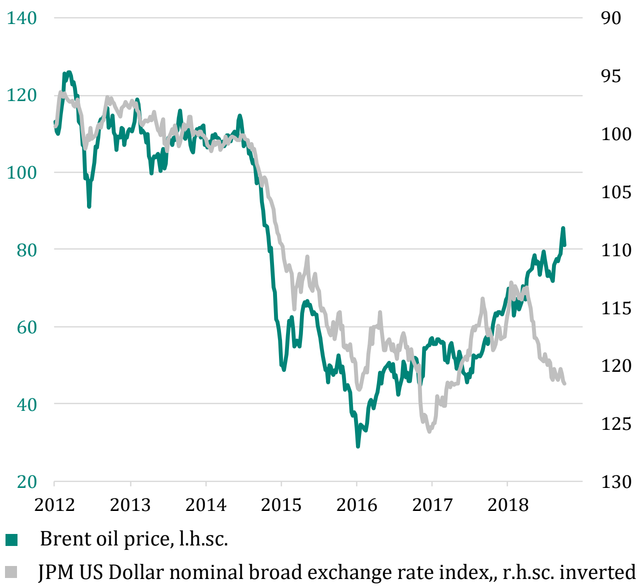
Looking into 2019, a gradual rebalancing and thus a moderate easing can be expected on global oil markets in our view. According to IEA forecasts, global demand will increase by 1.4 mbd in 2019. A large part of this additional demand is attributed to

Figure 8:
Sustained Oil Price Rally in 2018



source: Bloomberg

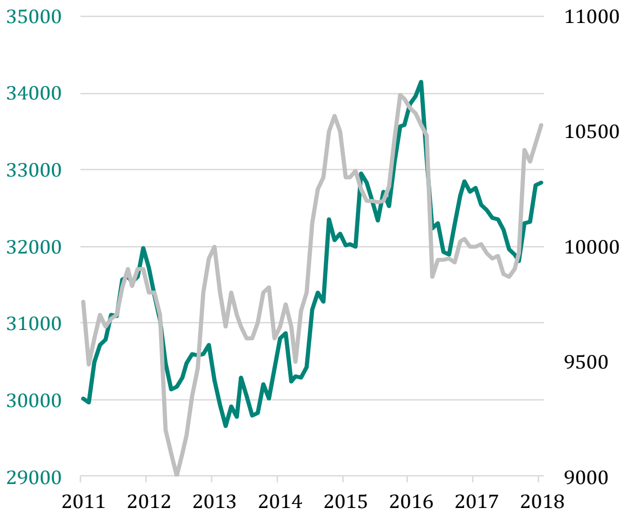
Figure 9:
Oil Price Decoupling from US Dollar Dependency



source: Bloomberg

emerging markets, primarily China and India. On the other hand, the increase in production of non-OPEC countries is estimated at 1.8 mbd to which the US is expected to contribute 1.2 mbd. Overall, these figures imply that the call on OPEC to balance the market will be reduced by 400k bd next year. In addition, given our outlook for the global economy in 2019 and the associated risks, the forecasted increase in global demand may prove too high. Demand could further be hurt in the case of spiking oil prices. We, therefore, do not rule out that this estimate of 1.4 mbd could be revised downwards in the coming months. This would also gradually shift the market focus from a pure supply side perspective towards driving factors on the demand-side. Overall, we, therefore, expect the Brent oil price to average at 73USD for this year and at 74USD for next year, which means a gradual easing in 2019 given current elevated price levels.

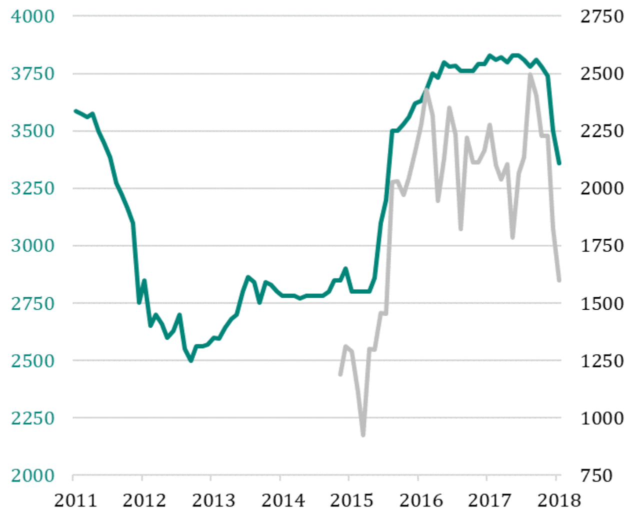
Figure 10:
OPEC and KSA Expanding Oil Output



OPEC oil production, in 1000 bd, l.h.sc.
Saudi Arabian oil prooduction, in 1000 bd, r.h.sc.

source: Bloomberg

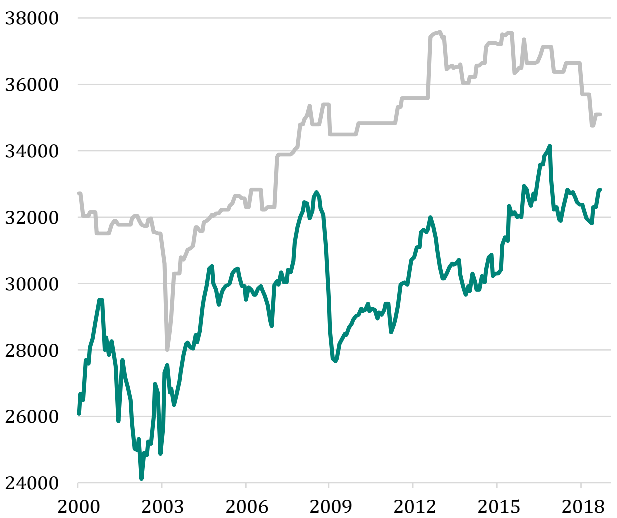
Figure 11:
Iranian Oil Output and Exports Affected by Sanctions



Iranian oil production, in 1000 bd, l.h.sc.
Iranian oil exports, in 1000 bd, r.h.sc. (data starting 07/15)

source: Bloomberg

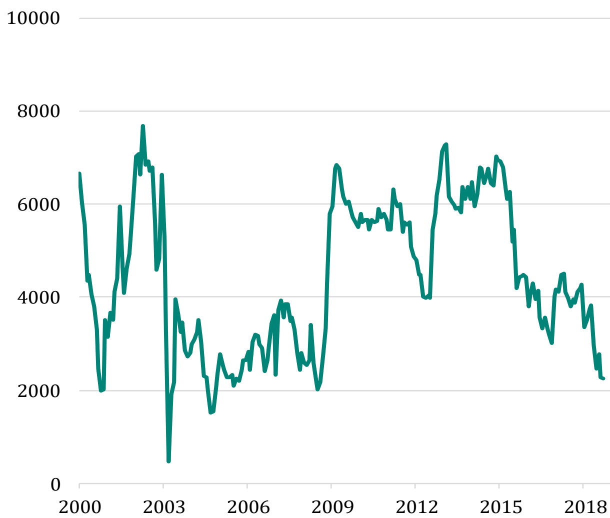
Figure 12:
OPEC Oil Output and Production Capacity



OPEC oil production, in 1000 bd
OPEC oil production capacity (Bloomberg estimate), in 1000 bd

source: Bloomberg

Figure 13:
OPEC Spare Capacity at Historic Lows



OPEC spare capacity (Bloomberg estimate), in 1000 bd

source: Bloomberg

Part 3: Saudi Arabian Economy

A Recovery Path Requiring Some GDP Forecast Revisions

Based on the latest data released by GASTAT the Saudi economy continued to recover in the second quarter of this year. Quarterly growth year-on-year rose by 1.6% after 1.2% in the first quarter. Both the oil sector and the non-oil sector positively contributed to this growth acceleration with 1.3% and 2.4%, respectively. In the case of the non-oil economy, however, the remarkable growth figure was mainly due to a rise in the payroll of the government sector, whereas the non-oil private sector expanded slightly more moderately at 1.8%.

For the third quarter, our GDP tracker models point to an accelerated continuation of the recovery trend (see figures 14 and 15). This is primarily due to a notable expansion in crude oil production, which will translate into a 4.0% GDP growth contribution by the oil sector. In the case of the non-oil private sector economy, however, various indicators signal an intermediate consolidation in this recovery process. For example, the point-of-sale transaction as an indicator of private consumption during the third quarter suggested a stabilization of growth, while the PMI index, the prime indicator of the non-oil economy's business climate, even showed a gradual decline from 55.1 in June to 53.4 in September.

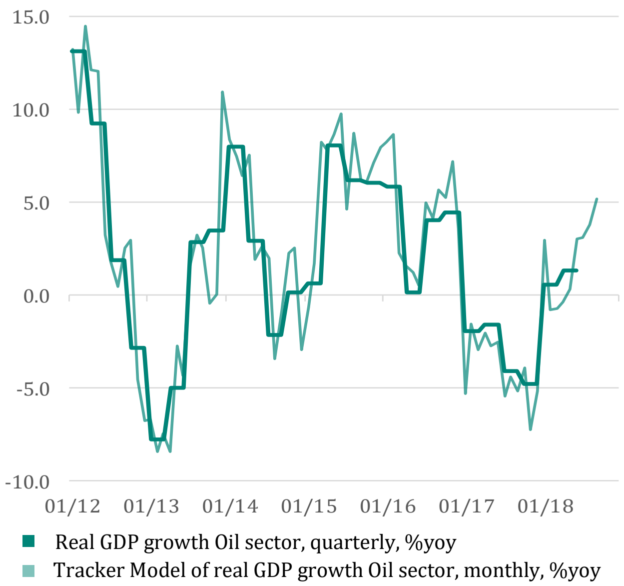
Based on these figures and our latest GDP tracker estimates we undertake the following revisions of our GDP forecast 2018. We gradually downgrade the growth rate of the non-oil private sector from 1.8% to 1.6%, while increasing the government sector's GDP growth contribution from 2.2% to 2.5%. Based on the latest actual data and Q4 projections for the oil production we raise our GDP growth estimate for the oil sector from 3.2% to 3.4%. Overall, our GDP growth estimate for the overall economy remains unchanged at 2.5%.

Pre-Budget Statement Signaling Fiscal Expansion

By the end of September, the finance minister announced a pre-budget statement for the following year which also contained a revised medium-term fiscal plan until 2021 as well as forecasts for real and nominal GDP growth over the next years.

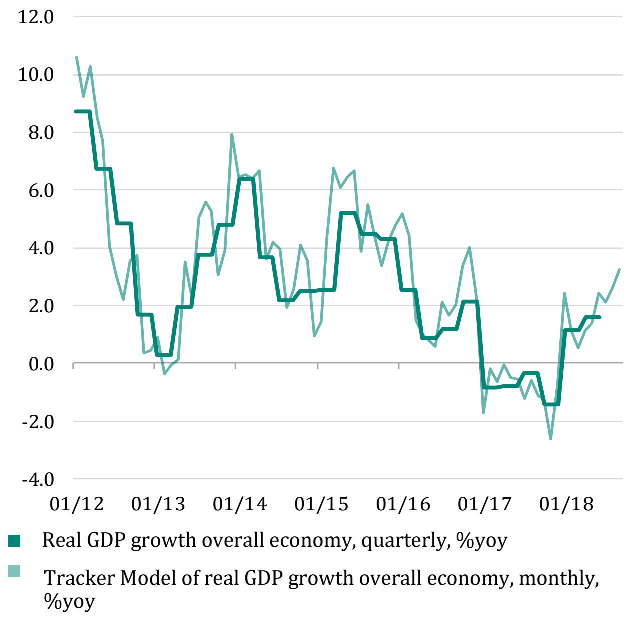
Compared to the previous medium-term fiscal plan, published in the budget announcement of last December, there are some notable changes. In particular, the government expects significantly higher fiscal revenues over the next three years. On average, the adjustment is in the order of 100bln SAR, for the year 2019 even 135bln SAR. It can be assumed that this revision is primarily due to higher budgeted oil revenues. According to the revised fiscal plan, these addi-

Figure 14:
Oil Sector GDP Growth Picking Up in 2018



source: Bloomberg, JODI, RC estimates

Figure 15:
Saudi Economic Recovery Gaining Pace



source: Bloomberg, SAMA, RC estimates

tional revenues are predominantly used to rise fiscal spending in order to spur growth of the domestic economy. Fiscal expenditures for the years 2019-2021 will be increased for each year by 90-100bln SAR. A focus is placed on increasing capital expenditure, which is supposed to represent a stronger and more sustainable growth impulse for the domestic economy than a corresponding increase in current spending.

Conservative Official Growth Forecasts

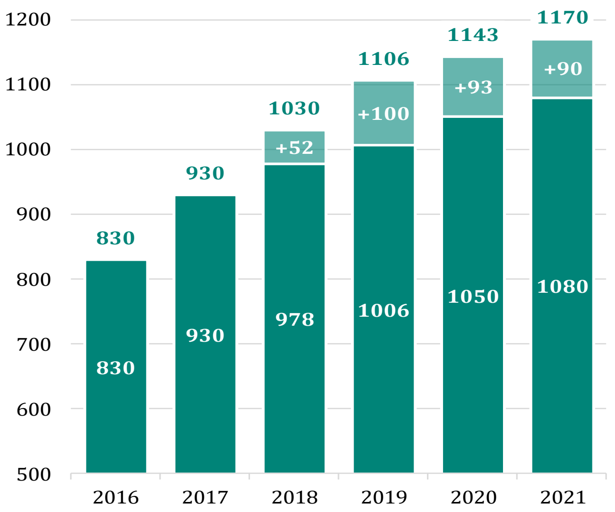
Against this backdrop, the official GDP growth projections released have to be considered as rather conservative. For the current year, GDP growth is forecasted at 2.1%, for 2019 at 2.3%, and for the following two years at 2.2% and 2.4% respectively. This is even more remarkable as the government forecasted in its budget announcement by the end of last year notably higher GDP growth rates (2.7% resp. 2.8% in 2019 resp. 2020) on the back of substantially lower spending targets. With a view on the expected oil output expansion towards to end of this year and into 2019 and taking into account the fiscal stimulus effect on the non-oil economy particularly in 2019 and beyond, we expect GDP growth for the Saudi economy to end up being above these revised official growth figures. Next to our GDP growth forecast of 2.5% for 2018, we expect a further growth acceleration in 2019 to 2.8%. The oil sector is forecasted to grow by 3.8%, while non-oil private sector GDP growth is expected to rise to 2.2%.

Regarding the budget projections for the current year, the forecasted fiscal deficit is clearly higher than our original projection (-148bln vs. -101bln SAR). This is partly due to on overspending beyond our expectations (1030bln SAR vs. RC forecast 1018bln SAR). In particular, however, the government forecast on total revenues is notably lower than our figures (882bln SAR vs. RC forecast 917bln SAR).

The source of this difference is most probably oil revenues estimates. In our view, differing oil revenues estimates are primarily caused by diverging assumptions on the fiscal transfer ratio (fiscal oil revenues as % of total oil revenues). In the past, this fiscal transfer ratio could be modelled as a function of oil prices. However, with the new tax regime for Aramco where part of previous tax payments is replaced by a presumably more stable dividend payment this relation may not be valid anymore. Based on our projections for oil exports and export prices, the government's oil revenues estimates would imply a fiscal transfer ratio of about 65%. This is clearly below the figure which would be expected based on the past relationship of the fiscal transfer ratio and the level of oil prices.

Finally, the new fiscal revenues projections also provide evidence that the government expects oil prices to stay at higher levels over the coming years. This is also confirmed by the official forecasts on nominal and real GDP growth over the next three years, based on which implied oil price projections can be derived.

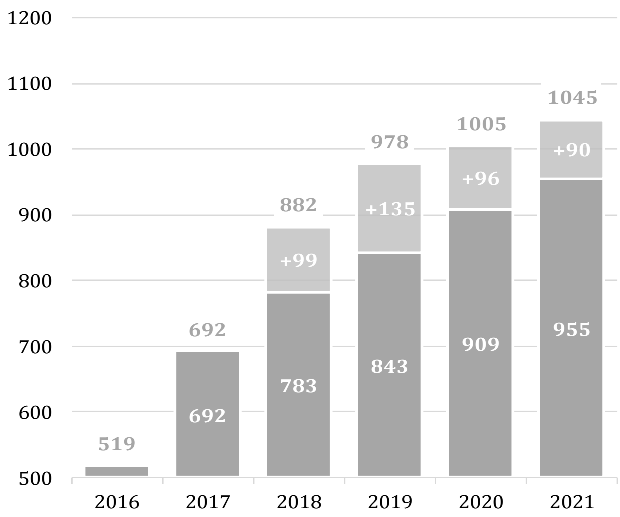
Figure 16:
Old and New Fiscal Expenditure Projections



Old medium-term fiscal expenditure projections, in bln SAR
Additional fiscal expenditure based on pre-budget statement 2019, in bln SAR
(2016, 2017 actual figures)

source: MoF

Figure 17:
Old and New Fiscal Revenues Projections



Old medium-term fiscal revenues projections, in bln SAR
Additional fiscal revenues based on pre-budget statement 2019, in bln SAR
(2016, 2017 actual figures)

source: MoF

Part 4: Global Financial Markets

Financial Market Corrections in October

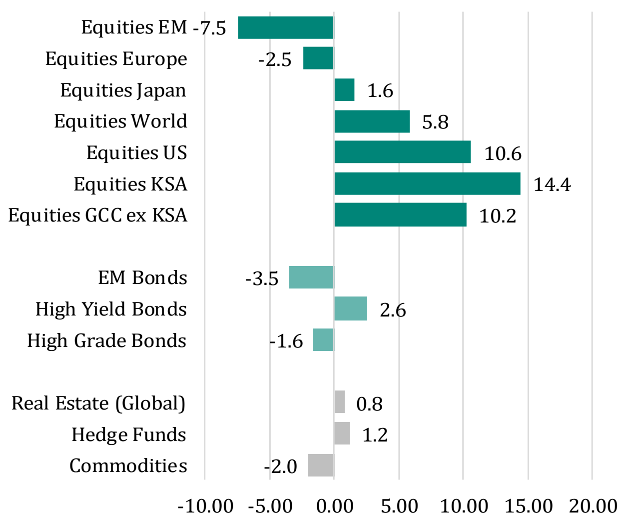
Global financial markets performed well overall in the third quarter (see figure 18). Developed equity markets, as measured by the MSCI World, gained 5.1% in Q3 2018, which constitutes almost the entire performance year-to-date (5.8%). In contrast to this, emerging markets continued to lose ground in the third quarter (-1.0%) which adds up to an overall negative performance of -7.5% since the beginning of the year. The Saudi stock market also corrected in the third quarter by -2.5%. Against the background of the expected slowdown of the global economy, which could be further compounded by the looming trade war, developed equity markets were remarkably resilient until the end of September. However, these worries ultimately triggered strong corrections on global equity markets in the month of October. In the first two weeks of the month, markets dropped by 5.0-7.5%. In view of these considerable corrections, we believe that a further weakening of economic indicators, such as the global PMI index for the manufacturing industry, is at least partially priced in at current levels (see figure 19).

The divergence between the US equity market and the rest of the World, which we already highlighted in our last report, has further widened in recent months (see figure 20). This is especially true for emerging equity markets. In fact, the S&P500 index outperformed the MSCI Emerging Market index by about 10% since the beginning of July this year until the end of September. A development that we anticipated by overweighting US equities and correspondingly underweighting EM equities in our mid-year asset allocation. This divergence is indeed fundamentally justified. The excellent economic stance in the US and, in particular, the corporate tax reform introduced in January have caused corporate earnings forecasts to be revised on the upside, while the opposite has happened in emerging markets due to the looming global economic slowdown (see figure 21). In the short term, it seems likely that this fundamental divergence will continue, but we expect the profit momentum in the USA to slow in the coming year as well, which should eventually also affect the equity market.

Strong US Dollar Weighing on Emerging Markets

We have on various occasions pointed out that a strong US dollar has a negative impact on emerging markets investments. This materialized in the recent months (see figure 22). Emerging equity markets have underperformed developed markets by nearly 20% since March of this year. Over this period, the trade-weighted US dollar index has risen accordingly. However, figure 22 also shows that the underperformance of emerging markets was disproportionately high and that a further strengthening of the US currency is already partially priced in at current levels.

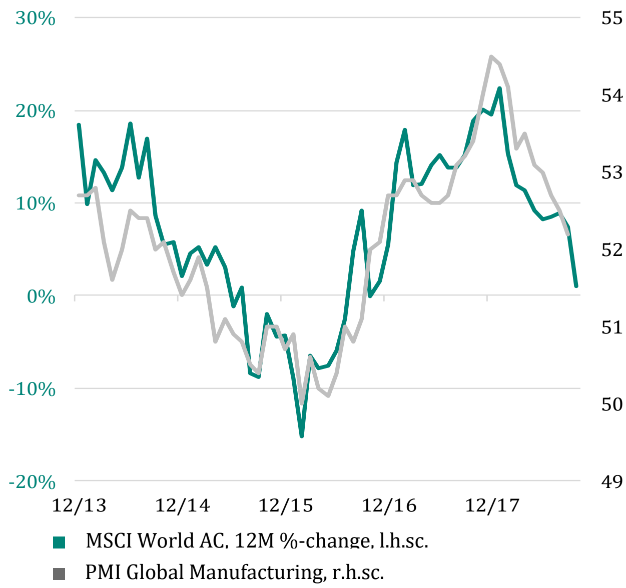
Figure 18:
Asset Class Performance September 2018YTD



Remarks:
- All return figures in USD
- Equity performance = total return (including dividend payments)

source: Bloomberg

Figure 19:
Global Equities Affected by Growth Slowdown



source: Bloomberg

An analysis of individual local equity markets within the Emerging Markets spectrum shows that even those markets, that were able to resist the general down trend to date, have now been hit by the global correction.

This is particularly true of the Indian equity market, which has been able to shine with excellent performance until recently. This favourable performance can be seen in the context of the strong growth of the Indian economy. Real GDP growth in the second quarter increased year-on-year by no less than 8.0%. This makes India one of the few major economies, along with the US, showing accelerating growth in the first half of 2018.

However, there are increasing signs that the Indian economy is also being affected by a slowdown. In its latest outlook, the IMF has reduced the growth forecast for 2019 to 7.4%. A key factor for this are high oil prices, which are affecting the Indian economy and also weigh on the trade balance. In addition, the Indian rupee has devalued against the US dollar since the beginning of the year by about 14%, which potentially could lead to increased inflationary pressure. The central bank is expected to raise interest rates by another 0.25% before the end of the year, after having hiked rates already twice this year. Furthermore, concerns about the stability of the banking system have also had a negative impact on the local equity market. Finally, the high valuation of the Indian stock market was another reason for the recent correction.

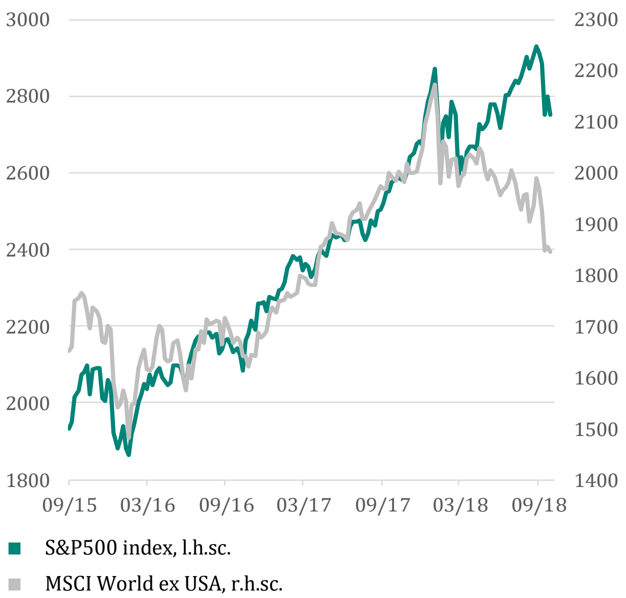
Rising US Bond Yields

Another driving factor that could increasingly be a problem for equity markets next to growth concerns are long-term interest rates, especially in the US. The yield on 10-year US Treasuries has risen clearly above 3% since its low of 1.36% in mid-2016. This year's increase was approximately 0.80%. As of mid-October, the yield on 10-year government bonds is about 3.20%. This increase over the past two years has to be seen against the background of an incrementally less expansionary US monetary policy. In its process of normalizing monetary conditions after the excessive liquidity creation in the aftermath of the global financial crisis, the FED has raised FED fund interest rates from 0.25% to 2.25% in the last two years (see figure 24).

A comparison with inflation-linked bonds shows that especially the yield increase during this year is mainly due to higher real interest rates (see figure 25) and not due to higher inflation expectations (difference between nominal and real US Treasury bond yields). Higher real interest rates reflect a stronger economy, which is fundamentally positive for equities. However, given the current strength of the US economy, inflation expectations could build over the coming months, which could lead to a further rise in interest rates to 3.5% or even higher. Under this scenario, long-term US interest rates could become a growing headwind for the equity market.

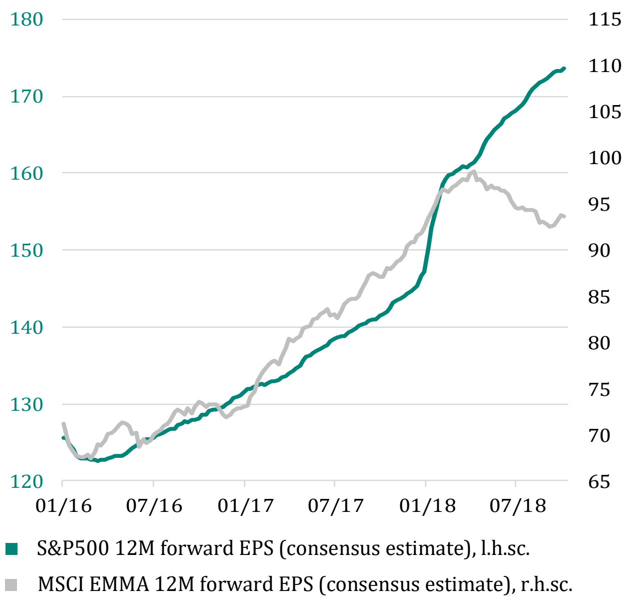
Against this backdrop, we take a more cautious stance

Figure 20:
Divergence between US and the Rest of the World



source: Bloomberg

Figure 21:
Diverging Earnings Trend US vs. Emerging Markets

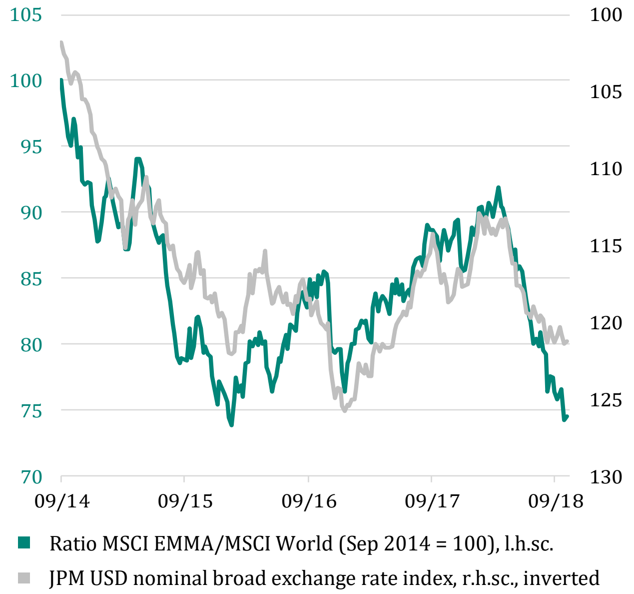


source: Bloomberg

on equities and are reducing our equity quota accordingly. This primarily affects US equities, which we downgrade from overweight to neutral on the basis of the above considerations.

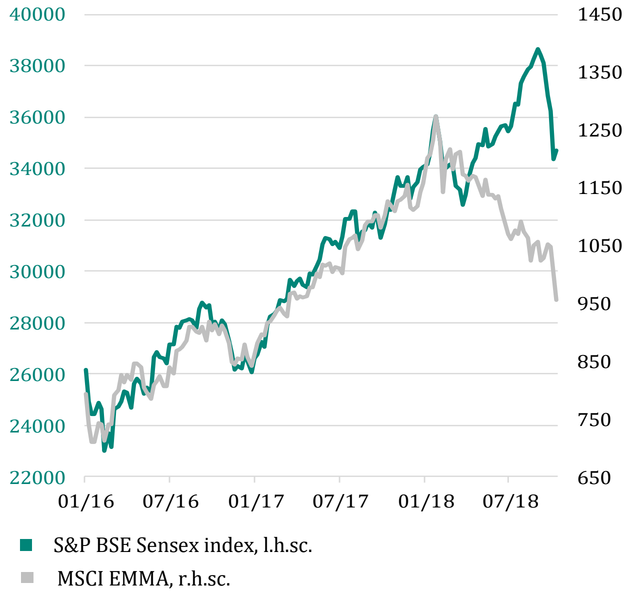
Our scenario of further rising US bond yields is also not a promising outlook for bond investors. For some time now, we have been significantly underweighting US Treasuries and high grade corporate bonds in our asset allocation. Over this period, we have always assumed that the process of monetary normalization will necessarily lead to rising long-term bond yields. We are still sticking to this. However, we believe that, at least in the US, this process is already well advanced and in the case of long-term yields in excess of 3.5% we should take a gradually more constructive stance on fixed income investments. We do not rule out that this could happen over the next year.

Figure 22:
Emerging Markets Affected by the US Currency



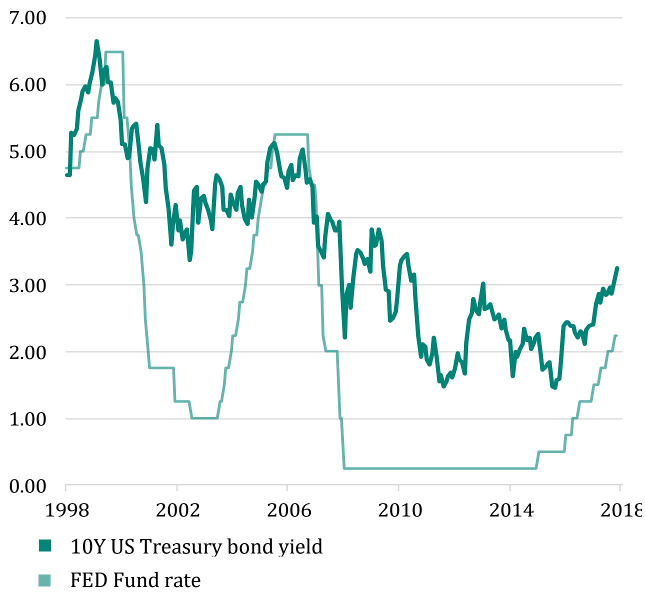
source: Bloomberg

Figure 23:
Indian Equities in Correction Mode after Strong Rally



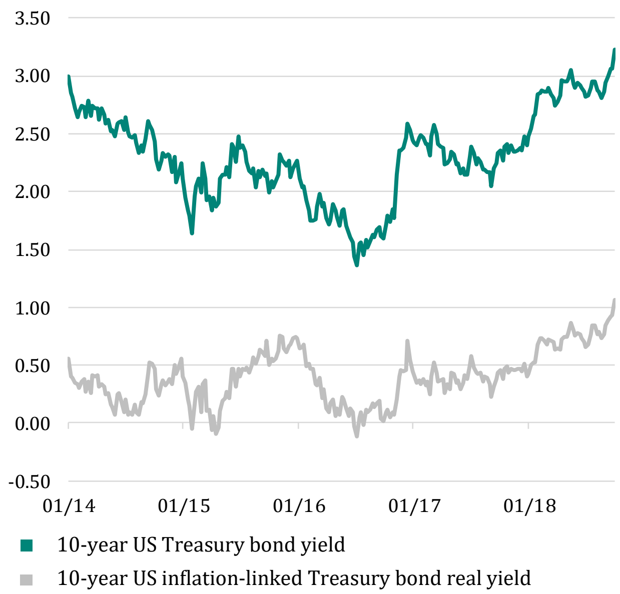
source: Bloomberg

Figure 24:
US Treasury Bond Yields Driven By FED Policy



source: Bloomberg

Figure 25:
Rising Bond Yields in 2018 due to Real Yield Pick up



source: Bloomberg

Part 5: Saudi Equity Market

Market Correction after Strong Rally in H1 2018

After a strong rally in the first half of the year, the Saudi stock market was subject to some corrections over the following months (see figure 26). From the beginning of January to mid-July, TASI rose from 7230 to just under 8500. The background to this rally, along with brightening fundamentals, was the news that Saudi equities would be included in the important global emerging market indices of MSCI and FTSE. The subsequent correction, which brought the market below the 7500 mark, is due to several factors. On the one hand, the lack of positive newsflow caused domestic investors to realize some profits. In addition, particularly in September and October, the currency crises of some emerging market countries, aggravated by geopolitical tensions, weighed on the Saudi stock market. As a result, investors are currently claiming a higher risk premium on Saudi equities than a few months ago.

Fundamental Case Remaining Valid

In our view, the fundamental scenario remains valid with respect to 2019. We continue to expect earnings growth of approximately 8% in 2019, after growth of around 7% in 2018. This against the background of the macro scenario of accellerated growth in the next year, described in part 3. On the basis of earnings-per-share (EPS) of Tadawul all-share index, this translates into a value of 482 SAR for 2018 and 521 SAR for 2019 (see figure 27). In our view, this still offers considerable upside potential for the Saudi equity market in the medium term.

The recent corrections have also triggered a revaluation of the Saudi equity market. The comparably high valuation levels by mid-year 2018 have been significantly revised downwards. For the 12M trailing PE-ratio, we are now below the long-term average (see figure 28), for the 12M forward PE-ratio, approximately at that level. Putting the Saudi market valuation in a global perspective by comparison to the MSCI World AC (see figure 29) reveals that Saudi equities currently exhibit a valuation discount of about -10% (relative 12M forward PE-ratios), with a long-term average centered at -5%. Figure 29 also shows that over the longer term, there is a positive correlation between the relative valuation to the global equity market and the price of oil, with the exception of the period from 2012 to 2014, when the stock market was clearly undervalued from this perspective. At the current level, there is still some scope for Saudi equities in terms of their valuation relative to global equities.

Diverging Sector Performance

A more granular look into the Saudi equity market reveals that there have been significant performance divergences between individual sectors over the past 12-18 months. In fact, the overall market was essentially driven by two sectors, banks and petrochemicals (see figure 30). Since the beginning of

Figure 26:
TASI Correction after Strong Rally in H1 2018

Tadawul All-share index (weekly chart)
50D MA

source: Bloomberg

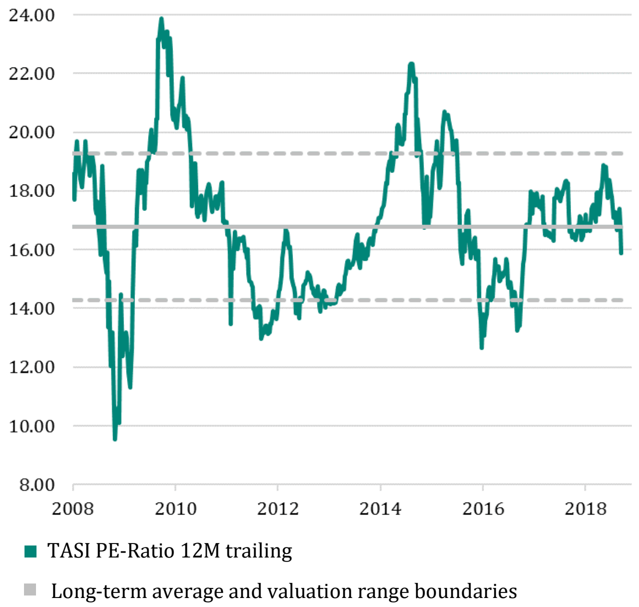
Figure 27:
Favorable Earnings Outlook into 2019

Tadawul All-Share index, l.h.sc.
4-quarter trailing EPS, r.h.sc. (dotted line RC forecast 2019)

source: Bloomberg

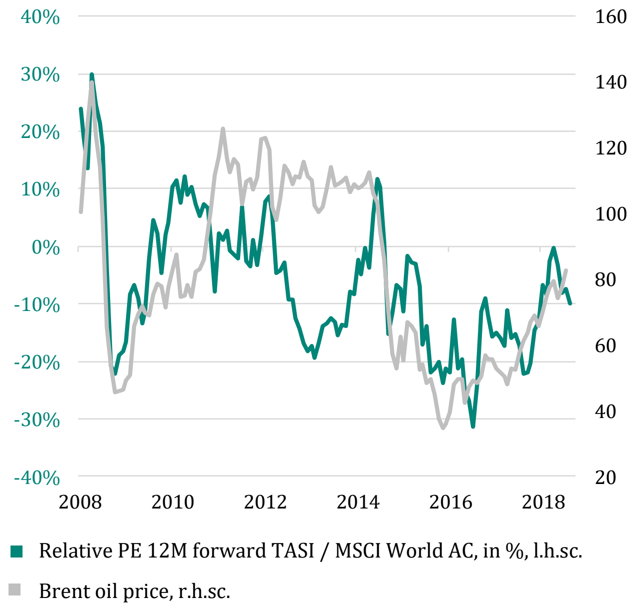
last year, the banking sector has outperformed the overall market by almost 30%, the petrochemical sector by about 20%. By contrast, over the same period, the real estate sector has underperformed by more than 35%, the consumer staples sector (Food & Beverage and Food & Staples Retailing), by around -25% (see figure 31). Behind this diverging performance is a differing earnings dynamics clearly in favor of the two outperforming sectors. Another driving factor contributing to these divergences is the index inclusion in the major EM indices by MSCI and FTSE. The majority of banks and petrochemicals are large cap stocks that are on the list of index inclusion candidates. About half of the 32 stocks expected to be included in the MSCI EM index are from these two sectors. Ahead of the index inclusion, this is likely to remain a performance driver for the market. Next to the still favorable fundamental outlook for these two sectors this doesn't advocate a major sector rotation at this juncture.

Figure 28:
Valuation in a Long-term Perspective



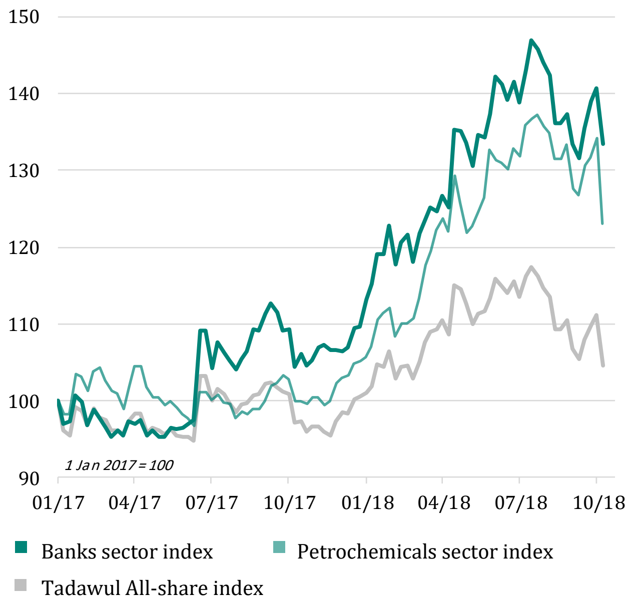
source: Bloomberg

Figure 29:
Valuation Relative to Global Equities



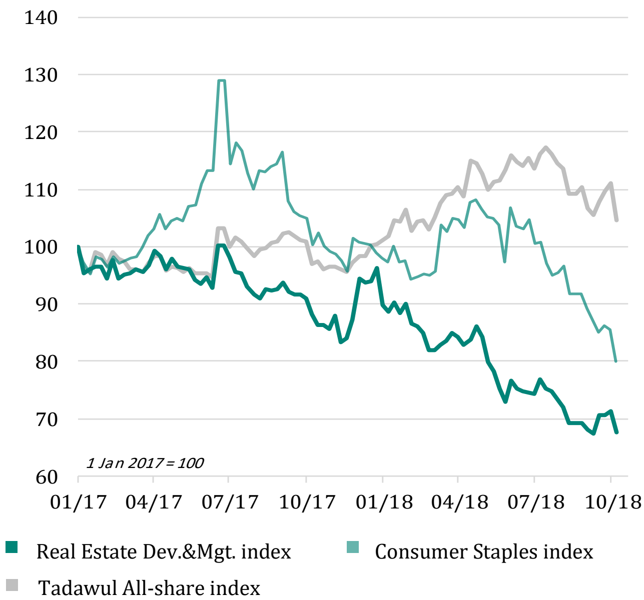
source: Bloomberg

Figure 30:
Banks and Petrochemicals Outperforming



source: Bloomberg

Figure 31:
Real Estate and Consumer Stocks Underperforming



source: Bloomberg

Performance Equity Markets

	2015	2016	2017	9/18
World (MSCI World AC)	**-4.3**	**5.6**	**21.6**	**2.2**
Adv. Economies (MSCI World)	**-2.7**	**5.3**	**20.1**	**3.8**
USA (S&P500)	-0.7	9.5	19.4	9.0
Euro Area (EuroStoxx)	8.0	1.5	10.1	-1.9
Japan (Topix)	9.9	-1.9	19.7	0.0
United Kingdom (FTSE100)	-4.9	14.4	7.6	-2.3
Emerging Markets (MSCI EM)	**-17.0**	**8.6**	**34.4**	**-9.5**
China (CSI300)	5.6	-11.3	21.8	-14.7
India (Sensex)	-5.0	2.0	27.9	6.4
Russia (Micex)	26.1	26.8	-5.5	17.3
Brazil (Ibovespa)	-13.3	38.9	26.9	3.8
Saudi Arabia (Tadawul)	-17.1	4.3	0.2	10.7

MSCI indices in USD, all other indices in local currency, price changes net of dividends

Valuation Equity Markets

	PE 17	PE 18	PB 18	RoE 18
World (MSCI World AC)	**20.6**	**15.9**	**2.3**	**11.0**
Adv. Economies (MSCI World)	**21.5**	**16.5**	**2.4**	**11.1**
USA (S&P500)	22.5	18.1	3.4	15.0
Euro Area (EuroStoxx)	19.6	14.4	1.6	8.1
Japan (Topix)	16.3	14.1	1.3	8.1
United Kingdom (FTSE100)	23.0	13.5	1.8	7.7
Emerging Markets (MSCI EM)	**15.7**	**12.0**	**1.6**	**10.0**
China (CSI300)	16.8	11.8	1.6	9.3
India (Sensex)	23.2	19.5	2.8	12.2
Russia (Micex)	7.2	5.8	0.8	11.4
Brazil (Ibovespa)	18.9	11.6	1.6	8.3
Saudi Arabia (Tadawul)	17.1	14.6	1.8	10.5

As of 30 Sep 2018
PE: price/earnings ratio, PB: price/book ratio, RoE: return on equity
all figures based on analysts' consensus estimates, Bloomberg

Central Bank Rates

	2015	2016	2017	*2018f*
Advanced Economies				
USA	0.50	0.75	1.50	*2.50*
Euro Area	0.05	0.00	0.00	*0.00*
Japan	0.10	-0.10	-0.10	*0.00*
United Kingdom	0.50	0.25	0.50	*0.75*
Emerging Market Economies				
China	4.35	4.35	4.35	*4.35*
India	6.75	6.25	6.00	*6.75*
Russia	11.00	10.00	7.75	*7.60*
Brazil	14.25	13.75	7.00	*6.65*
Saudi Arabia	2.00	2.00	2.00	*3.00*

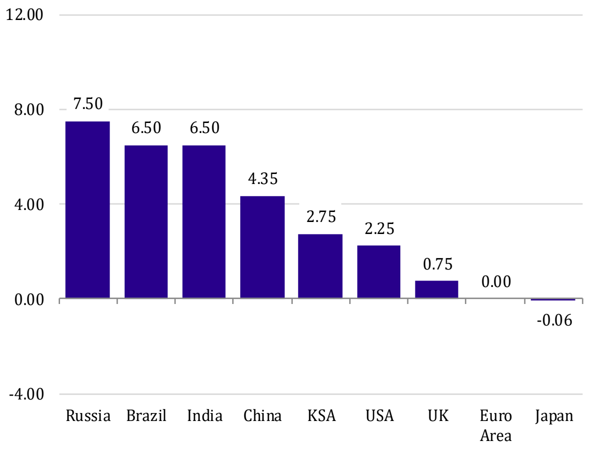
End of period, 2018 forecast

10-Year Government Bond Yields

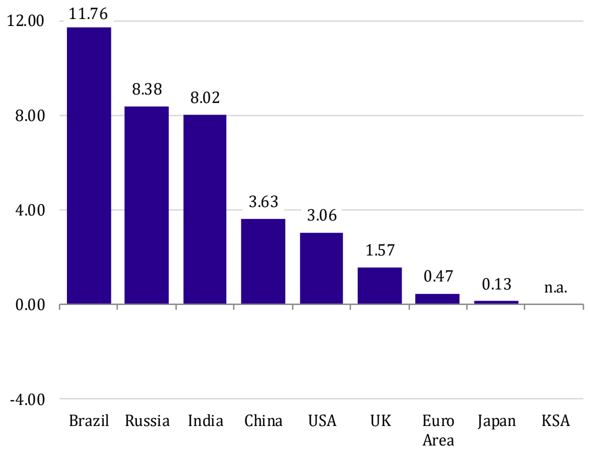
	2015	2016	2017	*2018f*
Advanced Economies				
USA	2.27	2.45	2.41	*3.40*
Euro Area	0.63	0.20	0.42	*0.65*
Japan	0.26	0.05	0.05	*0.12*
United Kingdom	1.96	1.24	1.19	*1.80*
Emerging Market Economies				
China	2.86	3.06	3.90	*3.50*
India	7.76	6.51	7.33	*8.00*
Russia	9.39	8.29	7.43	*8.40*
Brazil	16.51	11.40	9.80	*11.15*
Saudi Arabia	n.a.	n.a.	n.a.	*n.a.*

End of period, 2018 forecast

Central Bank Rates (as of 30 Sep 2018)



Government Bond Yields (as of 30 Sep 2018)



source: Bloomberg, RC estimates

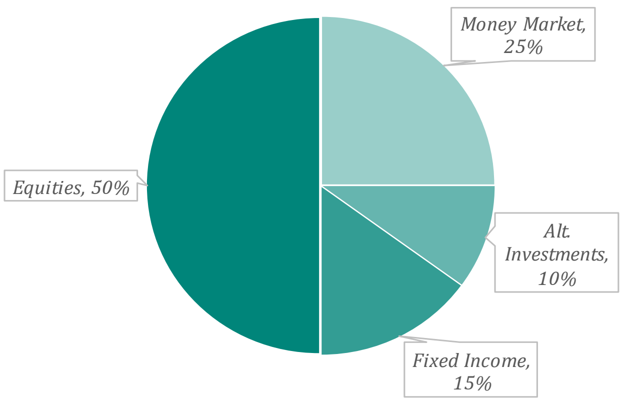
Part 6: Asset Allocation

Asset Allocation for Balanced Investor

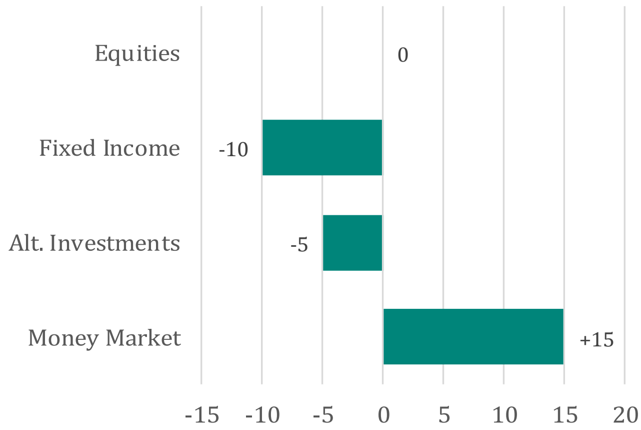
The following recommended asset allocation is tailored to an investor with a "Balanced" investment profile. This profile is reflected in the Strategic Asset Allocation which is an optimized portfolio structure based on the long-term risk/return-characteristics (i.e. more than 5 years horizon) of all asset classes considered. The Tactical Asset Allocation for the "Balanced" profile incorporates the short-to medium term investment view expressed in this document and translates into under- and overweights for each asset class compared to its strategic quota. Hence, these under- and overweightings reflect the relative attractiveness of different asset classes from a tactical perspective.

Asset Class	Tactical Allocation	Strategic Allocation	Over- / Underweight
Equities	**50**	**50**	**0**
Saudi Arabia	28	25	+3
GCC other	5	5	0
USA	10	10	0
Europe	4	4	0
Asia/Japan	3	3	0
Emerging Markets	0	3	-3
Fixed Income	**15**	**25**	**-10**
High grade bonds	5	15	-10
High yield bonds	5	5	0
Emerg. Market bonds	5	5	0
Alternative Investments	**10**	**15**	**-5**
Hedge Funds/Private Equity	5	5	0
Real Estate	5	5	0
Commodities/Precious Metals	0	5	-5
Money Market	**25**	**10**	**+15**
Cash SAR	25	10	+15
Total	**100**	**100**	**0**

Tactical Asset Allocation
(as of 30 Sep 2018)



Underweights / Overweights
(Tactical vs. Strategic Asset Allocation)



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